

Note prepared for EGoM

Annex 1

No.O- 19025/3/2012-ONG.D.V.
Government of India
Ministry of Petroleum and Natural Gas

SECRET

to on 21.10.2010 that EGoM has approved the price for 5 years from the date of commencement of supply and RIL was instructed to comply with the price so finalized.

3.11 On 9.1.2012, RIL, wrote a letter to Ministry of Petroleum & Natural Gas asking for a discussion on the revised price formula consistent with PSC. They further reiterated their request in their letter to the Ministry dated 30.1.2012. Their request was disposed of reiterating MoPNG stand that no revision can take place before the completion of the 5 year term.

3.12 Financial Implication:- RIL has proposed linking of gas price to international crude price. RIL has proposed the formula presented in case of CBM gas, according to which gas price will be ranging between \$ 14.20 to 14.51/MMBTU. In brief \$ 10/MMBTU increase in gas price will result in \$ 8.5 billion increase in revenue to the contractor in next two years and \$ 1.4 billion increase in revenue to Government in next two years in case the production remains constant at 37.5 MMSCMD. The difference in revenue to the contractor will be an addition of Approx. \$ 4.1 billion and to the Government \$ 0.5 billion in case the Gas production from this block is taken as per the projection made by the Contractor. In the second case the production is assumed to be 25.08 MMSCMD in 2012-13 and 18.7 MMSCMD in 2013-14. As most of the gas produced is being used by fertilizer units and power units supply power to State Discoms, the burden on State and Central Governments will go up by around \$ 10.5 billions due to increase of \$10.0 in domestic gas price in the first scenario. In the scenario of falling production, the increase in subsidy burden is likely to be \$ 6.3 billion.

4. PSC Provisions:

4.1 The following are important provisions of the PSC, impacting the fixation of natural gas. The copy of relevant Articles of PSC is annexed to this note (Annexure VII at pages 114-117).

EXECUTIVE SUMMARY OF CAG REPORT

Annexure 2

In practice, however, the private contractors have inadequate incentives to reduce capital expenditure and substantial incentive to increase capital expenditure or "front-end" capital expenditure, so as to retain the IM in the lower slabs or to delay movement to the higher slabs.

The structure of the IM-based profit sharing formula (especially when there is a huge jump in Gol's profit share from 28 per cent to 85 per cent on an IM slab of 2.5 or more) is such that in certain scenarios, an increase in capital expenditure, upto a point, could conceivably result in an increase in the contractor's share of profit petroleum, despite a reduction in the total profit petroleum as well as Gol's share of profit petroleum. Further, "front-ending" of capital expenditure (i.e. skewed towards the initial phases) decreases the IM, and postpones the movement to higher IM slabs; this results in a reduction in Gol share on a discounted cash flow basis, since the slabs involving higher Gol share come later, rather than earlier.

Operational control of E&P operations is largely with the private operators, and the Gol's oversight role is restricted essentially to its representation (through MoPNG and/ or DGH) in the Management Committee for the block, especially in approval of Annual Work Programmes and Budgets and Field Development Plans, as well as a few approval functions delineated in the PSC.

Ashok Chawla Committee Report

We are given to understand that the report of the Ashok Chawla Committee on allocation of natural resources also draws similar conclusions regarding the IM-based profit-sharing formula. This committee had, inter alia, representatives from MoPNG and the Ministry of Finance, so it can safely be presumed that its conclusions were well considered. However, the report is not currently available in the public domain.

According to media reports, the Committee has stated that the system "gives incentive (to an operator) to increase his investment, or front-end his work plan in order to see that the threshold where Government's profit take rises rapidly is not reached". Citing the example of KG-DWN-98/3, the Committee has stated that "the relationship between the pre-tax IM and the share of contractor profit petroleum changes dramatically once the pre-tax IM crosses 2.5, with the government's share increasing from 28 per cent to 85 per cent. It is useful to remember that this schedule is bid by the operator, and not determined by the Government."

Further, according to the Committee, "a high share of some pre-tax IM will help to win the bid, depending on the financial mode of evaluation used, but it does raise concerns that such a radical change would provide very strong incentives for any operator to adopt all investment and strategies possible to ensure that the pre-tax IM stays within the 2.5 limit".

The report clearly points out the risks associated with the IM-based formula for sharing of profit petroleum, especially with a steep jump in profit sharing from one slab to another. In our view, even the linearity introduced in the sliding scale for IM slabs from NELP-VII onwards does not fully address these risks.

We, therefore, recommend that in the case of the KG-DWN-98/3, MoPNG carefully validate the award of the following contracts on the basis of a single financial bid so as to draw assurance that government interests have been protected.

S.No.	PO No.	PO Date	Order Placed on	Original PO Value (US\$)	Item Description
1.	86759	06.10.2007	Aker Borgestad Operations AS	276,443,000	Operation & Maintenance of FPSO RIL Equipment and Operation of Subsea Equipment in connection with production of Oil & Gas
2.	3627982	04.05.2007	Aker Floating Production/ Aker Contracting FP ASA	1,094,002,520	Chartering of FPSO facility in connection with extraction and production of Oil & Gas
3.	3639935	20.09.2007	Aker Installation FP AS, Norway	281,118,779	Installation of Subsea Facilities
4.	3370813	03.07.2006	Aker Kvaerner Subsea AS Norway	431,284,407	Supply of subsea hardware
5.	310783	27.09.2006	Aker Kvaerner Process System	1,000,000	License Agreement for MEG R&R Plant
6.	3610783	20.10.2006	Aker Kvaerner Power Gas / Aker Power Gas Pvt. Ltd.	100,000	Services relating to MEG R&R Plant
7.	3610598	15.09.2006	Aker Kvaerner Process System	5,914,800	Engineering of MEG Regeneration and Reclamation plant
8.	3392654	30.09.2006	Aker Kvaerner Process System	16,154,400	Supply of key equipment for MEG Regeneration & Reclamation package
9.	3391768	27.09.2006	J. Ray McDermott Middle East Inc.	206,990,342	Supply, loadout & seafastening of CRP
10.	3611331	26.09.2006	J. Ray McDermott, Eastern Hemisphere	122,558,268	Transportation, installation, testing and pre-commissioning

Legend

	Contracts relating to MA oilfield.
	Contracts relating to MEG Regeneration & Reclamation package.
	Contracts relating to Installation of CRP

- As indicated by the operator, advance action was taken to tie up vendors for timely development of D1/D3 fields in anticipation of the MC approval of the AIDP. While a view could, perhaps, be taken that such pre-approval action is at the risk and cost of the contractor, in reality, this increases the probability of such approvals becoming a fait accompli.

Since approval of estimates does not constitute acceptance of the cost projections of the operator, validating the cost incurred by him can be done only after audit of the actual cost through proper norms. Part of the expenditure in respect of Individual Items under AIDP incurred during 2006-07 and 2007-08 has been audited. Remaining expenditure incurred from 2008-09 onwards will be covered in future audits.

(Para 4.3.1)

Procurement-related activities

We found that payments during 2006-07 and 2007-08 revealed instances of huge procurement contracts where we could not derive assurance as to the reasonableness of costs incurred, primarily due to lack of adequate competition – award on single financial bids; major revisions in scope/ quantities/ specifications; post-price bid opening; substantial variation orders - with consequential adverse implications for cost recovery and GoI's financial take.

In particular, regarding the MA oilfield, we found that well before submission, let alone approval, of the Field Development Plan (FDP) and Mining Lease (ML) application, the operator had placed orders for various critical items required for development activities/ production facilities from 2006 itself. We also found serious deficiencies in the award, on a single financial bid, of a 10 year hiring contract for US\$ 1.1 billion for a Floating Production, Storage and Offloading (FPSO) vessel from Aker Floating Production (AFP).

(Para 4.4)

During our scrutiny of the operator's records, we have come across instances, where multiple vendors were pre-qualified. However, when technical bids were received, all vendors (except one) were rejected, and the contract was finally awarded on a single financial bid.

In our opinion, such disqualification of vendors on technical grounds, after a pre-qualification process and bidders' meetings for technical clarifications, limits the competitiveness which is not in accordance with the spirit of the procurement procedure given in the PSC. In many cases, it resulted in no competing financial bids, and the contract was awarded on the basis of a single financial bid. In such a situation, the letter and spirit of the MC's role at the pre-qualification stage is vitiated.

Consequently, in our opinion, in cases of procurement (under procedure 'C' – high value contracts), where pre-qualified bidders are subsequently disqualified/ declared non-responsive on various technical and other grounds and there is only one financial bid being considered, the Operator should either go back to the pre-qualification process, and ensure that more vendors/ parties are pre-qualified. Alternatively, if the operator wishes consideration of only a single financial bid, the matter has to be necessarily referred back to the MC (including GoI representatives)/ GoI for ex ante relaxation from PSC stipulated procurement procedures. Post facto approval of the MC may be provided for in emergent cases, with adequate justification.

46. While the EGOM meetings were being held the litigation between RIL and NTPC, and RIL and RNRL were in various stages before the High Court. It appears that while exercising its sovereign right to frame policy of national importance, EGOM was also sensitive to the issue of decisions to be made by the concerned courts, and hence noted that the decisions of EGOM would be without prejudice to the rights of the litigants as decided by the Courts.

47. A final order and judgment was passed, on 15.10.2007, by the Learned Company Judge. The judgment held: the Application under Section 392 to be maintainable, that the Company Court was not competent to dictate the specific changes sought, that the GSMA was in breach of the Scheme, that the MoU was binding on both parties, and that "suitable arrangements" in Clause 19 of the Scheme had to be read in light of the MoU and that it was necessary for the Scheme. The 155

Learned Company Judge also held that such gas supply contracts would be subject to Government's approval, pursuant to NELP and PSC and it was further held that Government should normally approve such contracts unless clearly in breach of public policy and public interest. The Learned Company Judge then ordered the parties to renegotiate.

48. Both sides filed appeals before the Division Bench against the said judgment. As a number of interim orders were passed at the stage of the proceedings before the Learned Single Judge and then later on before the Division Bench, the GoI intervened in the proceedings as it had been realized that it had a vital stake because the dispute involved issues that could affect national development, national interest and also GoI's revenues.

49. The Division Bench disposed off the appeals of RIL and RNRL by its order and judgment dated 15.06.2009. The decision at the level of the Division Bench turned, it seems, on the fact that a portion of the MoU was jointly tendered by RIL and RNRL and apprehension of the Division Bench that under the PSC, RIL is entitled to a physical share of natural gas, as a part of cost gas and profit gas. Further, the Division Bench seemingly agreed with 156

the conclusions of the Learned Company Judge and then departed from it. Substantively it was held that a fixed quantum of 28 MMSCMD plus 12 MMSCMD in the event that NTPC contract did not fructify stood allocated and to be supplied for use in any of REL's power projects, and that the allocations made were a class apart in themselves. The price of supply was to be in accordance with the PSC - but as there was no clause in the PSC prohibiting RIL from selling it at a price lower than that arising from the price formula/approved by the Government, natural gas up to the first 40 MMSCMD at a well head price of USD 2.34/mmBtu of natural gas stands allocated to RNRL, as RIL would still make profits at that price point. Further, the Division Bench also ordered the parties to renegotiate with respect to issues regarding identity, definition of affiliate and limitation of liability to make the gas supply agreements bankable.

50. There is considerable confusion as to what the Division Bench ordered with respect to Utilisation Policy and its applicability with respect to the Option Volumes of natural gas provided for in the MoU. The three parties to this case have urged three different interpretations regarding the same. 157

51. Aggrieved by the said Judgment and Order of the Division Bench all the parties have approached this Court in appeal by way of special leave. The Union of India which was allowed to intervene before the Division Bench, being aggrieved by certain findings, has also preferred an appeal against the Judgment and Order of the Division Bench. After initially raising objections, the Learned Senior Counsel appearing for RNRL, Shri. Ram Jethmalani withdrew his objections to leave being granted. Further, in as much as on the face of the record it would appear that the PSC, to which the UoI is a party, has been interpreted without the GoI having had an opportunity to be properly impleaded and present its case and the potentially serious public interest implications that arise therefrom, leave has been granted to the UoI.

LETTER from MOPNG
TO RIL

18. Clause 3.2 of the Accounting Procedure (Appendix C to the PSC) deals with costs and expenses which shall not be recoverable or allowable (whether directly as such or indirectly as part of any other charges of expense) for cost recovery and profit sharing purposes under the PSC. In terms of sub-clause (ix) of clause 3.2 of the PSC, the amounts paid with respect to non-fulfillment of contractual obligations shall not be recoverable or allowable for cost recovery and profit sharing purposes under the PSC.

19. Your breach of PSC including failure to adhere to and comply with the Amended IDP have resulted in heavy loss of production of gas thereby causing loss to the Government and of a scarce natural resource to the nation. You are not entitled to the recovery of costs incurred by you for the excess capacity created in block KG-DWN-98/3 and such recovery of costs has to be limited only to the extent of the infrastructure used by you for the production of gas. In view of the aforesaid, the following cumulative cost (which are provisional and subject to verification and finalization by the Government) for the respective years is inadmissible.

(i) For 2010-11: USD 457,000,000 (US Dollar Four Hundred and Fifty Seven Million)

(ii) For 2011-12: USD 1,005,000,000 (US Dollar One Thousand and Five Million)

Further, it would also be fair and reasonable, in order to ensure compliance with the approved Amended IDP, that the disallowed Contract Costs shall be added to the respective Petroleum computed under clause 16 of the PSC for sharing between the Government and the Contractor.

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TIMELINE FOR RIL KG-6 Allocation

1997	Introduction of NELP
1999	First block awarded under NELP (9 rounds of allocation are over, 10 th to start very soon)
2000	KG-DWN-98/3 (KG-D6) block awarded to RIL
2000 (Apr)	PSC signed
2003 (Apr)	Declaration of Commercial Discovery (DoC) notified in D-1
2004 (Mar)	Declaration of Commercial Discovery (DoC) notified in D-3
2004 (May)	Initial Development Plan (IDP) submitted envisioning capex of 2.39 Bn USD (40 MMSCMD)
2004 (Nov)	IDP approved by Management Committee
2006 (Oct)	Addendum to IDP (AIDP) submitted envisioning capex of 5.2 Bn USD (80 MMSCMD)
2006 (Nov)	Revised AIDP submitted envisioning capex of 8.8 Bn USD
2006 (Dec)	AIDP approved by Management Committee
Unknown	DoC notified for D-26 (MA Oil field)
2007 (Aug)	Separate Development Plan submitted for D-26 with capex of 2.23 Bn USD
2008 (Apr)	Separate Development Plan approved by Management Committee
2008 (Sep)	Oil production starts in D-26 oil field
2009 (Apr)	Gas production starts in D1-D3

Source CAG Report

TIMELINE FOR RIL & Government interactions

2004	RIL quoted 2.34 USD/MMBTU for supply of 12 MMSCMD of gas to NTPC for a period of 17 years
2006 (Jan)	RNRL and RIL sign a contract for purchase of 28 MMSCMD of gas
2006 (Apr)	RIL proposes gas price formula which calculates cost as 2.34 USD/MMBTU
2006 (Jul)	Government rejects the proposed formula on the basis that formula not derived on the basis of competitive arms length sales
2006 (Aug)	MoPNG constitutes committee under chairmanship of J Sec and Fin Adv
2006 (Nov)	Committee submits report but it deals with gas valuation when no arms length price determination is possible
2007 (May)	RIL submits revised price proposal
	CDS rejects the formula
2007 (Aug)	EAC submits its report to PM
2007 (Sep)	EGoM holds its meeting and basis COS and EAC recommendations it approves formula for gas pricing. The price works out to be 4.2 USD/MMBTU for 5 years from the beginning of production
	Immediately RIL submits its consent to the terms & conditions of the price fixation including the period of price fixation
2010 (Sep)	RIL represented that they have an offer of purchase of gas at higher rate than the one approved by EGoM
2010 (Oct)	RIL was replied that EGoM suggested price would remain valid till 2014
2011 (Jul)	GOI approves BP and RIL deal of 30% stake transfer
2012 (Jan)	RIL wrote twice to MoPNG to discuss a revised formula linked to International crude price. Twice the request was rejected that no revision before 2014
2012 (Feb)	EGoM in its meeting decided to seek advice of Attorney General for India (AGI)
2012 (May)	AGI gives his view that 'one cannot ignore the fact that the price was fixed till 2014'
	MoPNG opines that revision of natural gas pricing is not appropriate before 2014. Ministry also agrees with AGI that it is not appropriate to refer the matter to any regulatory authority
2012 (Aug)	Production of gas in KG Basin falls from 35 MMSCMD (Feb 2012) to 28 MMSCMD

Source: Note prepared by MoPNG on 10th Oct 2012 for EGoM

THE PREVENTION OF CORRUPTION ACT, 1988

13. Criminal misconduct by a public servant :

(1) A public servant is said to commit the offence of criminal misconduct,-

(d) if he,-

(i) by corrupt or illegal means, obtains for himself or for any other person any valuable thing or pecuniary advantage; or

(ii) by abusing his position as a public servant, obtains for himself or for any other person any valuable thing or pecuniary advantage; or

(iii) while holding office as a public servant, obtains for any person any valuable thing or pecuniary advantage without any public interest; or

(e) if he or any person on his behalf, is in possession or has, at any time during the period of his office, been in possession for which the public servant cannot satisfactorily account, of pecuniary resources or property disproportionate to his known sources of income.

Explanation.-For the purposes of this section, "known sources of income" means income received from any lawful source and such receipt has been intimated in accordance with the provisions of any law, rules or orders for the time being applicable to a public servant.

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